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January 27, 1999 **Ex Parte**

Magalie Roman Salas
Secretary
Federal Communications Commission
445 - 12th Street, SW - TW-A325
Washington, D.C. 20554

Re: CC Docket No. 96-262

Dear Ms. Roman Salas:

On January 26, 1999, the undersigned, along with Jay Bennett (SBC), Ed Googe (Bell Atlantic), Robert McDonnell (Bell Atlantic), BB Nugent (U S WEST) and Vic Wakeling (BellSouth) met with Steve Spaeth, Tamara Preiss, Jay Atkinson, Chris Barnekov, John Scott, Florence Setzer and Aaron Goldschmidt of the Common Carrier Bureau. The attached material was the basis for the discussion.

Pursuant to Commission Rule 1.1206(b)(2), an original and one copy this letter and attachments are being provided to you for inclusion in the public record for the above-referenced proceeding. Please contact me with any questions.

Sincerely,

Linda Kent

Linda Kent
Associate General Counsel

attachments
cc: S. Spaeth
T. Preiss
J. Atkinson
C. Barnekov
J. Scott
F. Setzer
A. Goldschmidt

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COMPETITIVE TRANSITION MECHANISM (CTM)
FOR FCC PRICE CAP SERVICES IN COMPETITIVE MARKET AREAS

PROPOSAL
USTA's CTM proposal permits pricing flexibility for a service only in market areas which meet a specified competitive trigger. The PCI would no longer govern the rates for that service demand in the competitive market. Rates for those same services in areas *not* deemed sufficiently competitive will remain governed by the PCI. The CTM proposal protects against concerns of cross-subsidy between the regulated and competitive services that are out from under the Price Cap. This CTM is dynamic and avoids the need for complicated and contentious cost allocations and exogenous adjustments.

Regulated ratepayers continue receiving productivity benefits from "GDPPI – X".
At each annual filing, the price cap formula updates the PCI. The required PCI changes under the current Price Cap rules would be implemented, but the updated PCI would only apply to the service demand that remains in regulated market areas. Thus, at each tariff update, the PCI (t) would be calculated based on only the service demand still in regulated service areas at the tariff effective date. Rates for these PCI-governed services would still fall by the percentage required by the 'GDPPI – X' formula. Likewise, the API would be calculated based on actual rates and only regulated demand.

No PCI 'headroom' is derived from removing competitive services.
Demand associated with services that meet the necessary competitive triggers would remain interstate but be treated as 'removed' from under the Price Cap. Because the competitive demand and associated revenue is excluded from the regulated baskets and the PCI formula, any lower prices in the competitive service areas will not create additional headroom which could otherwise allow for increased prices in less competitive areas.

Removing some service demand will lower the total dollars of headroom (when headroom previously existed). However the market conditions that caused headroom to exist in the first place are not negated by removing some competitive services. In the case where there is no existing headroom, i.e., the API=PCI, the process of removing some competitive demand also does not generate headroom for the remaining services. *(Refer to example in next section)*

Impact on Indices
The removal of services from price caps is straightforward and is done without any impact on the rates of services that remain under price caps. The PCI changes only in an annual (or exogenous cost) filing and is equal to the previous PCI increased or decreased by the percent change in inflation minus productivity and exogenous cost changes which are incorporated as a percent of base period revenues. As no changes to these factors would be incorporated in the filing to remove competitive service demand, the current PCI would remain unaffected by a change in base period revenues. The carrier simply removes the base-period competitive service demand and calculates the new (reduced) revenue level associated with the basket from which

the demand was removed. Reducing the base period demand and revising the overall basket revenue level associated with the base period demand that remains within the basket is the step that makes it mathematically possible to leave the index of allowable prices (PCI) and the actual prices (API) relationship unchanged.

In other filings during the tariff year, the annual filing's base-period demand for price cap services is further reduced by the level of base-period demand associated with any additional competitive services removed. Any price changes associated with the services remaining in the basket under the PCI will reflect the (reduced) level of base period demand. For the subsequent year's annual filing, the base period demand will be updated and will reflect the service demand then remaining under Price Caps in the baskets.

The SBIs for the service categories work in a manner similar to the APIs. Like the API, the SBIs are also a function of the relative change in actual rates, so that if there is no change in rates of services remaining under price caps, there is no change in the SBI.

CONCEPTUAL EXAMPLE 1
Assume a Price Cap basket initially has three regulated interstate services.
Assume pricing below the cap (headroom) is due to market pressure on Service BB rate.

Service	Price Cap Base period Demand	Rate at PCI	Rate at API	Revenue at PCI	Revenue at API	PCI - API Headroom
AA	100	$5.00	$5.00	$500	$500	
BB	400	$2.00	$1.00	**$800**	**$400**	
CC	1,000	$1.00	$1.00	$1,000	$1,000	
			TOTAL ->	$2,300	$1,900	**$400**

Assume 100 units (out of 400 base-period BB demand) meet competitive trigger for removal.
A TRP is filed to update the regulated base-period demand for the competitive demand removed.

Service	**Updated Base Period Demand**	Rate at PCI	Rate at API	**Updated Revenue at PCI**	**Updated Revenue at API**	PCI - API Headroom
AA	100	$5.00	$5.00	$500	$500	
BB	**300**	$2.00	$1.00	**$600**	**$300**	
CC	1,000	$1.00	$1.00	$1,000	$1,000	
			TOTAL ->	$2,100	$1,800	**$300**

See Attachment A and Exhibit 1 for a detailed description and example of the PCI impact of removing services from price cap regulation.

OUTCOME UNDER USTA'S CTM:

- ***Rates for the remaining Price Cap demand continue in compliance with the Price Cap rules.***
- ***Removing some competitive service demand will reduce the PCI and API revenue for the basket but the removal itself does not disturb the continuing Price Cap PCI, API rate relationship.***
- ***Removal of competitive service itself does not increase 'headroom'; instead, removing competitive service demand will reduce any previously existing total 'headroom' revenue.***

Reporting/Monitoring

"Removed" service demand would be confidential. Each time additional services qualify for removal based on the competition threshold, a revised 'informational' TRP will be filed. This 'informational' TRP will update and restate the regulated demand and revenue compared to the regulated base-period levels in the previous annual filing. This 'informational' TRP will provide a current summary of regulated demand and confirm compliance with the Commission's Price Cap rules throughout the intervening period before the next annual filing.

When competitive thresholds are achieved in other market areas, at other times during the period, updated 'informational' TRP filings will be provided. Thus, the ILEC will provide a continuing TRP record of compliance for remaining regulated demand as additional competitive base-period demand is removed from under the PCI over time.

As long as the annual FCC Form 492A interstate earnings report is required, the total revenue reported will be the combined total of both Price Cap regulated and removed service revenue. The total of all removed services revenue, which is embedded in the overall Form 492A revenue, will be reported as a separate item of information. For the sake of competitive neutrality and competitive sensitivity, removed service is tracked in the aggregate only for the TRP entity, by summing actual revenue for each competitive service over their market areas.

LFAM reduction allowance for 'removed' competitive services

The following adjustments would apply when 'removed' and regulated service revenues are combined and the reported earnings warrant an LFAM adjustment. A reduction to the LFA amount from regulated ratepayers will occur whenever an ILEC's actual average competitive service rates are below the corresponding average tariff rate.

If LFAM is triggered, the removed service demand will be repriced at the corresponding average Price Cap tariff rate. If the repriced revenue exceeds the actual removed service revenue included in the low earnings, the full LFA amount will be reduced. LFA recovery is lowered by the revenue increment that the repriced revenue exceeds the actual competitive service revenue. Under this conservative adjustment, lower competitive revenues associated with competitive prices below average tariff rates will lead to a reduced LFA recovery from regulated rates. The greater the competitive-to-tariff rate differential, the greater the downward LFA adjustment.

Second, once any initial LFA reduction has been determined, the reduced LFA amount is then allocated proportionally between actual total regulated and removed service revenue shares. In other words, if the reduced LFA amount is $80 million and total actual FCC Form 492A Revenues are 90% regulated and 10% removed service revenue, then regulated rates could rise only $72 million (90% of reduced $80 million LFA). As a second layer of conservatism in the CTM, $8 million of the LFA revenue adjustment must be borne by the removed services.

Please see attachment (Exhibits 2 and 3, "LFA Adjustment for Removed Services - High Cap Example") for a more detailed display of the LFAM adjustments.

Safeguards against Cross-subsidy

Allowing ILECs' competitively neutral pricing flexibility in competitive service areas will permit the ILEC to compete more vigorously in those markets. Competitive pricing flexibility under this CTM does not translate into an opportunity to shift revenue recovery from competitive to Price Cap regulated services.

While interstate earnings are above the LFAM level, the ILEC's shareholders would bear the reduced earnings from any elective price reductions. Second, the ongoing PCI constraint for regulated services would restrict raising Price Cap rates as an offset to recover further revenue reductions in competitive areas. Finally, the CTM includes two adjustments that will indemnify regulated ratepayers by reducing the LFA amount when interstate earnings are low.

Ease of Implementation

This CTM proposal simply requires distinguishing service base-period demand quantities at each filing between that which is under price cap regulation and that which is not. Thus, at any future point, all interstate demand then would be in either one of two categories, regulated or removed from the Price Cap, respectively. As competition expands over time, the service demand will shift out from under the PCI.

Allowing pricing flexibility is not contingent on burdensome and contentious cost or investment allocations. Consequently, no exogenous adjustments are needed to recognize the removal of competitive services.

Reported interstate earnings will combine actual revenues from both regulated and 'removed' interstate services. Costs and average net investment will be determined under the existing rules.

Removing Services from Price Caps

The removal of services from price caps is a fairly simple process. It would not affect the current level of any price cap indices if performed in a filing in which there are no PCI changes and no changes are made to any of the rates for services remaining under price caps. Exhibit 1 provides illustrative details of this process.

Section 1 of Exhibit 1:

As provided in section 1 of Exhibit 1, assume three services make up a given basket. Further assume PCI and API (columns e and f) are equal to 72.02 and 71.88, respectively, and initial headroom (column h) is equal to $13.71 given the demand and price quantities in columns a and b.

Section 2 of Exhibit 1:

Next, as provided in section 2, assume 100 demand units of service B are removed from price cap regulation. After removal, demand (column a) and actual revenue (column c) are reduced. However, none of the indices would change. The PCI (column e), which represents the maximum allowable overall price level of services in a basket, is equal to the previous PCI increased or decreased by the percentage change in inflation minus productivity and exogenous cost changes which are incorporated as a percentage of base period revenues. Since no changes to these factors would be incorporated in the filing the current PCI would remain unaffected by the removal of demand for service B. The API (column f), which measures actual price changes, also would not change with the removal of high cap services in a filing with no rate changes proposed. (The constancy of the API is demonstrated below in Section 3).

Most importantly, however, headroom revenue (column h) would actually decrease (to $13.03) as services are removed from price caps. This is because the change in headroom equals the change in actual revenues times the PCI divided by the API minus one. The headroom that remains reflects the same PCI/API relationship, but as applied to a reduced price cap revenue base.

Section 3 of Exhibit 1:

The API (column e) is unaffected by the simple removal of services from price cap regulation. The proposed API equals the current API times the proposed change in prices, measured by the sum of the revenue-weighted proposed price change ratios for each element in the basket. When demand and revenues are removed from price caps, the total base period revenues, which are the denominator in the revenue weights, become smaller, increasing the percent of revenues associated with each of the services that remain under price caps. This change in weighting, however, has no effect on the current API, as long as no rate changes are proposed. This is because the revenue weights are multiplied by the ratio of proposed/current price for each rate element (column c), which equals 1 when no rate changes are proposed. The result is a set of new revenue weightings each multiplied by one, that when added up still equal 1.0 (column e). The existing API multiplied by 1.0 yields the same value for the proposed API. In any subsequent filing that would propose rate changes, the new revenue weightings would come into play, as they become the basis for calculating proposed changes in the API. These new revenue weightings would actually result in greater regulatory control for remaining services, as each service would comprise a higher proportion of total revenues remaining under price caps. (The SBIs for the service categories work in a manner similar to the APIs. Like the API, the SBIs are also a function of the relative change in actual rates, so that if there is no rate change in rates of services remaining under price caps, there is no change in the SBI.)

Conclusion:

Since the existing price cap indices are unchanged when services are removed in the manner described above, there is no additional "headroom" created by this process. Indeed, some headroom (where headroom exists) is actually lost. The ratio of actual price levels (API) to maximum allowable price levels (PCI) remains the same. In the case where there is no headroom prior to removal of services (API=PCI), then the PCI/API=1 and no matter what the magnitude of the dollar amounts associated with the services removed from price caps, there will be no headroom made available for the remaining services under the proposed methodology.

Section 1 - Baseline:

All Services Currently Under Price Cap

Service	Demand	Rate	Actual Revenue	Percent Revenue	PCI	API	Max Allow Revenue	Head-Room	Headrm/ Max Rev
	a	b	c=a*b	d	e	f	g=c*e/f	h=g-c	i=h/g
A	250	$7.75	$1,937.50	0.2753					
B	600	$3.50	$2,100.00	0.2984					
C	1,500	$2.00	$3,000.00	0.4263					
Total Basket			$7,037.50	1.0000	72.02	71.88	$7,051.21	$13.71	0.19%

Section 2 - Removal:

100 demand units of service B removed from under price caps

Service	Demand	Rate	Actual Revenue	Percent Revenue	PCI*	API**	Max Allow Revenue	Head-Room	Headrm/ Max Rev
	a	b	c=a*b	d	e	f	g=c*e/f	h=g-c	i=h/g
A	250	$7.75	$1,937.50	0.2897					
B	500	$3.50	$1,750.00	0.2617					
C	1,500	$2.00	$3,000.00	0.4486					
Total Basket			$6,687.50	1.0000	72.02	71.88	$6,700.53	$13.03	0.19%

Section 3 - API:

Pursuant to Part 61.46(a) API is not Impacted

Service	Price Before Removal	Price After Removal	Prop/Curr Rate	Percent Revenue	Weighted Change	API(t-1)	API(t)
	a	b	c=b/a	d	e=c*d	f	g=e*f
A	$7.75	$7.75	1.0000	0.2897	0.2897		
B	$3.50	$3.50	1.0000	0.2617	0.2617		
C	$2.00	$2.00	1.0000	0.4486	0.4486		
Total Basket					1.0000	71.88	71.88

*PCI does not change because there are no exogenous or productivity factor changes in the filing.

**API does not change because there are no rate changes made to price cap services in the filing.
The API (t) = API (t-1) times the sum of each rate element's ratio of proposed/current price weighted by its percent of total revenues:

LFA Adjustment for Removed Services - High Cap Illustrative Example
Dollars in thousands

Step #1: Actual 1997 Price Cap Earnings Data

	Source	Total IS Access	PC Services	Removed Svcs
1 Revenues	492A and Company Records	$ 3,224,051	$ 3,099,165	$ 124,886
2 Exp + Taxes	492A	$ 2,853,048		
3 Return	Ln 1 - Ln 2	$ 371,003		
4 ANI	492A	$ 3,742,251		
5 ROR	Ln 3 / Ln 4	9.91%		

Step #2: Calculate LFA on total interstate access basis

	Source	Total IS Access
6 Return @ 10.25%	Ln 4 * .1025	$ 383,581
7 Actual return	Ln 3	$ 371,003
8 Difference	Ln 6 - Ln 7	$ 12,578
9 Gross-up for Taxes (@ .40)	Ln 8 / 0.60	$ 20,963

Step #3: Calculate revenue differential attributable to removed services

	Source	DS1	DS3
10 Removed svcs rev	Company Records	$ 85,286	$ 39,600
11 Ratio of PC/removed svc ARPU	Lns 13 and 14, Exhibit 3	1.0707	1.1119
12 Removed svcs rev adjusted	Ln 10 * Ln 11	$ 91,316	$ 44,031
13 Revenue differential	Ln 10 - Ln 12	**$ (6,030)**	**$ (4,431)**

Step #4: Adjust total LFA for removed services revenue differential

	Source	LFA Adjustment
14 Total LFA	Ln 9	$ 20,963
15 Revenue differential	Ln 13 (DS1 + DS3)	$ (10,461)
16 Revenue adjusted LFA	Ln 14 + Ln 15	**$ 10,502**

Step #5: Allocate portion of revenue adj LFA to price cap services

	Source	Total IS Access	PC Services	Removed Svcs
17 Total revenues actual	Ln 1	$ 3,224,051	$ 3,099,165	$ 124,886
18 Revenue distribution		100.00%	96.13%	3.87%
19 Allocation of LFA	Ln 16 * Ln 18	$ 10,502	**$ 10,095**	$ 407

Calculating Ratio of Price Cap to Removed Services Average Revenue Per Unit (ARPU)
Example for Removal of DS1 and DS3 Services in Some Geographic Areas

Step #1: Calculate actual ARPU for removed services

		Source	Amount
1	Actual DS1 revenue from removed svcs	Company Records	$ 85,286,160
2	DS1 chan terms removed	Company Records	236,906
3	Rev/unit (ARPU) removed	Ln 1 / Ln 2	**$ 360.00**
4	Actual DS3 revenue from removed svcs	Company Records	$ 39,600,000
5	DS3 chan terms removed	Company Records	12,000
6	Rev/unit (ARPU) removed	Ln 4 / Ln 5	**$ 3,300.00**

Step #2: Calculate ARPU for corresponding price cap services (after removal date)

7	DS1 service cat. Revenues	TRP	$ 213,074,289
8	DS1 service cat. chan terms	TRP	552,782
9	Rev/DS1 (ARPU) under price caps	Ln 7 / Ln 8	**$ 385.46**
10	DS3 service cat. Revenues	TRP	$ 66,047,600
11	DS3 service cat. chan terms	TRP	18,000
12	Rev/DS3 (ARPU) under price caps	Ln 10 / Ln 11	**$ 3,669.31**

Step #3: Calculate ratio of PC/removed ARPU

13	DS1 services ratio	Ln 9 / Ln 3	1.0707
14	DS3 services ratio	Ln 12 / Ln 6	1.1119